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BOTTOM OF THE NINTH

Priorities for the Federal Reserve

Gary H. Stern

President
Federal Reserve Bank of Minneapolis

Editor's note: On Sept. 1, 2009, Gary Stern retired as president of the Minneapolis Fed. This is his final Top of the Ninth; the column has been retitled temporarily to honor the conclusion of a distinguished and long-lived series.

I have spent the last 30 years working with some of the world's most accomplished and sophisticated economists, both academic and applied. All this wisdom has, perhaps ironically, confirmed that the most important lessons from economics are its simple ones. One could go far in setting good policy by keeping in mind the importance of incentives and the absence of a free lunch.

The latter point means that resources are scarce. This has implications for big-picture solutions to the problems of the day, and it also has straightforward implications for households, firms and government, including the Federal Reserve: All of these organizations must prioritize their objectives. We can't do it all, even though many possible activities are beneficial and important. With this in mind, I will devote the rest of this essay to a summary of where I think the Federal Reserve should focus. And in doing so, I will concentrate on incentives. By getting its incentives right and, where appropriate, helping to align the incentives of other participants in the economy with desired outcomes, the Federal Reserve can accomplish its ultimate mission of making society better off.

I see the following priorities for the Federal Reserve: (1) adopting an explicit inflation target to assist in achieving the dual mandate of monetary policy, (2) enhancing financial stability and supervision of systemically important financial institutions to address the too-big-to-fail problem, and (3) targeting Federal Reserve payments policy and activity on improving the integrity of the payments system. This is a broad and challenging list; I will elaborate briefly on each objective.

Inflation targeting and the dual mandate

The Federal Reserve has no choice but to pursue the dual mandate of high employment and price stability, both because it is in legislation governing the institution and because it is sound policy. Without getting into the debate about exactly how much

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monetary policy, as opposed to the underlying structure and dynamics of the economy, can contribute, I would emphasize that the two components of the dual mandate go hand-in-hand in the long run. This observation is not news; it is fully consistent with macroeconomic theory and with the experience of the past two-plus decades. An explicit inflation target would on the margin assist in achieving the mandate because it would help to anchor price expectations and reduce uncertainty about the course of policy, permitting economic actors to focus on "real" activity. In particular, diminished uncertainty would aid private sector decision-making and resource allocation, thus raising the probability of attaining and sustaining high employment. Note that an inflation target would be of value in periods of both inflationary and deflationary concerns, rendering the economy less prone to either outcome.

Financial stability

Many observers have recognized that incentives mattered a great deal in producing the financial crisis of the past two years. This view has led to a focus on reworking compensation for those working at financial institutions, altering fixed income securities rating rules and improving consumer regulation. While all worthy of attention, I think the most important incentive to address concerns policymakers' rationale for providing ex post support to creditors of systemically important financial institutions. If policymakers do not alter the incentives that lead to bailouts, creditors will continue to expect them and fail to provide an effective market check against excessive risk-taking.

In my view, the threat of financial spillovers drives such protection, as policymakers seek to limit the fallout from one financial institution to another or to significant financial markets. In this context, I support proposals to establish a "macroprudential supervisor" and think the central bank is best positioned to assume this role. I have noted elsewhere my views on how macroprudential supervision can make spillovers less likely, or at least less threatening, and thus strengthen incentives to permit policymakers to avoid bailouts. In short, the macroprudential supervisor should gather the data necessary to identify spillovers and what policymakers should do, by way of advance preparation, to enable them to impose losses on creditors. If these steps are not taken, the TBTF problem—and the instability that follows from it—will only grow.

I have not previously explained why the Fed should take on the responsibilities of macroprudential supervision, so let me elaborate. The Federal Reserve possesses a talented and experienced staff; it has a broad network of domestic and international contacts; it is knowledgeable about a wide range of markets and institutions. But far more importantly, the Federal Reserve is the lender of last resort—the only domestic institution capable of providing significant amounts of liquidity on virtually a moment's notice. It is sound policy that the institution with this unique capability be assigned the responsibility for financial stability, recognizing of course that in a market economy bouts of instability are virtually inevitable from time to time even with the best efforts of public authorities.

If the Federal Reserve becomes the macroprudential supervisor, it should have oversight responsibility for systemically important financial institutions, bank and nonbank alike. These are likely to be large, complex organizations for the most part, along with a few institutions especially critical to particular markets. The central bank does not have to be the principal supervisor of all such institutions, but it has to have ready access to accurate information about these firms, sufficient hands-on

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I would also argue that in pursuing financial stability, the Federal Reserve should necessarily give more weight than it has before in its policy deliberations to fluctuations in asset prices. As we have seen twice this decade, collapses in asset prices can have very serious, disruptive consequences for the performance of the economy, consequences that are far from easy to offset. Further, I do not think that moral suasion or conventional supervisory powers are likely to be effective in this area. While admittedly challenging to attend to, excesses in asset prices will have to be addressed with monetary policy in my judgment.

Payments system integrity

The Federal Reserve has long played an important role in the payments system of the country, engaging in activities running the gamut from provision of coin and currency to paper check processing to processing and settling both small- and large-dollar electronic payments. Payments have become increasingly electronic over the past 10-15 years, and the Federal Reserve has adjusted accordingly, with the change illustrated most dramatically perhaps by the sharp and rapid reduction in the number of check-processing sites.

Taking a cue from this development, the central bank should review how to continue to add significant value to the payments system while being careful about the volume of resources devoted to this objective. Such a review would lead, in my judgment, to an emphasis on maintaining and enhancing the integrity of the system. Given the private sector's demonstrated capability in retail payments, I think this observation implies an emphasis on large-dollar electronic payments, where the finality of payment and the depth of infrastructure provided by the central bank are absolutely critical to both the confidence in and performance of the system.

Conclusion

The list of significant policy objectives I have just described is just that—a description, from my perspective, of the highest priorities for the Federal Reserve for, say, the next decade. This is not to say that the System shouldn't continue to fulfill other ongoing responsibilities or to undertake new activities if assigned. But the central bank cannot do all tasks with equal fervor and attention. So it must allocate its scarce resources, and the three areas noted above capture my sense of where the greatest allocation should occur. It will not prove sufficient, however, if the Federal Reserve simply does "more" in the areas I mentioned. It must also seek to align its own and private incentives in the direction of welfare-improving tasks. R